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UCITS funds turn to securities lending

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UCITS funds turn their attention to securities lending

UCITS funds have historically shunned securities lending due to regulatory restrictions, but this is changing. Joanna Ksenzova, associate director of securities finance at RBC Investor & Treasury Services in Luxembourg, shares her insights on three industry developments which are transforming how UCITS funds approach securities lending

UCITS lendable assets are growing. At a time when pressure on margins and revenues is increasing, asset managers — including those regulated under the Undertakings for Collective Investments in Transferable Securities (UCITS) regime — are looking for new ways to supplement their traditional return streams, and offset custody and administration fees. Securities lending is one of the options available to managers.

DataLend reports that income from securities lending has been healthy, noting that the global securities finance industry generated US$4.8 billion in revenue for lenders in the first half of 2022, a 6 per cent increase from the US$4.5 billion accumulated during the same period in 2021. The data provider also indicates that revenue obtained from fixed income securities jumped by 22 per cent year-on-year, fuelled by rising fees and growing on-loan values in corporate debt, while proceeds from equities were up 2 per cent.

Meanwhile, data from S&P Global Market Intelligence shows that €2.2 trillion of UCITS assets were enrolled in securities lending programmes as of 1 August 2022. UCITS lendable assets have more than doubled over the past five years from nearly €1 trillion and are growing faster than the industry average. Asset composition remained stable during this period, with equities representing approximately 70 per cent of on-loan assets, corporate bonds close to 20 per cent and government bonds around 10 per cent. In addition, UCITS managers engaging in securities lending are on average adding another three basis points (bps) to their overall performance. In the case of a UCITS that is focused on emerging markets or ETFs, securities lending could generate up to 15bps in extra revenues.

"Despite the naysayers, UCITS assets in lending programmes are continuing to grow as managers look to supplement their portfolios with this important revenue stream in what is a highly competitive environment," Ksenzova says.

The UCITS lending process is manageable

Second, according to Ksenzova, one of the biggest barriers for UCITS lending programmes is the perception of a complicated lending process. "Regulators are requiring more and more disclosure in UCITS fund prospectuses and regulatory reporting, including details at the sub-fund level," she says. "It is important for UCITS managers to carefully consider the lending requirements that apply to UCITS, including such things as collateral title transfer and segregation, aligned correlation and diversification, as well as the concentration rules to be performed on aggregated collateral from various efficient portfolio management (EPM) techniques."

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In addition, managers must ensure that assets can be recalled at any time and establish collateral stress-testing, when required. "Cash collateral remains another issue, as UCITS funds face some unique reinvestment challenges. And UCITS funds need to be able to price the services of external providers and perform best execution controls." Ksenzova also notes that EU regulations such as the Central Securities Depositories Regulation (CSDR) and Securities Financing Transactions Regulation (SFTR) have created additional operational hurdles for asset managers — including UCITS funds — when lending their securities.

Although the existing UCITS framework around securities lending can be somewhat onerous, it is not insurmountable. "These issues are manageable for UCITS funds, but they need to be conscious of the additional work and costs involved, relative to the estimated returns," says Ksenzova. "I would encourage UCITS managers to work with an experienced agent lender, who can support them with the legal, due diligence, and all other go-live and post-trade requirements that are associated with securities lending." She says that UCITS managers are also outsourcing various risk and compliance functions to third-party management companies (ManCos) and "these companies have been working with UCITS funds for many years to successfully support securities lending".

> *"Moving forward, the lending industry needs to refine its data management around ESG so that both UCITS and non-UCITS managers can benchmark whether their securities lending practices are compliant with ESG requirements"*

When UCITS funds and their providers have the necessary provisions in place, "the resulting lending process is both efficient and automated — not much different from other funds in terms of day-to-day involvement of the funds", says Ksenzova. "While the compliance and reporting obligations to service UCITS funds are high, this tends to drive process optimisation and automation."

Marrying securities lending with ESG

Reflecting on a third key industry trend, Ksenzova notes that, over the past few years, there has been extensive debate among investors about whether securities lending is compatible with environmental, social and governance (ESG) investing. For example, some investors contend that short-selling does not align with their ESG principles, while others have looked to strengthen their proxy voting policy, amend their lending policies and require agents to confirm that collateral does not contravene ESG mandates. Ksenzova says this has been particularly challenging for UCITS funds, which are generally subject to more stringent transparency requirements for securities lending and ESG. "The situation is further complicated by UCITS funds' focus on cross-border distribution."

ESG investing — for UCITS and non-UCITS managers alike — suffers from a lack of regulatory clarity on transparency and reporting requirements, compounded by an abundance of industry standards tackling sustainability, many of which tend to be loosely defined and somewhat contradictory. While ESG is notoriously open to interpretation, agent lenders, ManCos and asset owner lenders have been working closely together to ensure that securities lending practices are compatible with the funds' ESG requirements.

"Agent lenders will closely monitor the lending of securities if there are potential risks around sanctions, tax, distressed assets or illiquidity. We are focused on best practices and maintaining a strong reputation in our industry," says Ksenzova. At the same time, agent lenders are working to ensure that the collateral posted by borrowers to lenders does not include assets that could potentially raise awkward questions around ESG, she notes.

"Moving forward, the lending industry needs to refine its data management around ESG so that both UCITS and non-UCITS managers can benchmark whether their securities lending practices are compliant with ESG requirements and the funds' individual mandates for ESG." Ksenzova concludes: "The securities lending market requires greater standardisation of ESG requirements and this is something we are working towards." ■

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*Global Investor/ISF Beneficial Owners Survey - Custodial Lender Category Unweighted, 2021